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IN THE
UNITED STATES COURT OF APPEALS FOR
THE NINTH CIRCUIT

JOHN G. GROVES, Trustee,
Appellant,
vs.
FRESNO GUARANTEE SAVINGS
AND LOAN ASSOCIATION,
Appellee,

NO. 20,581

APPELLANT'S OPENING BRIEF

FULLERTON, LANG & RICHERT
520 Guarantee Savings Bldg.
Fresno, California 93721

FILED

Attorneys for Appellant

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JURISDICTIONAL STATEMENT

Notice of appeal was filed with the District Court on November 4, 1965 (R. 39). * Appeal is taken from the Order of the District Court entered on October 5, 1965 (R. 36).

The United States Court of Appeals for the Ninth Circuit is vested with jurisdiction of this appeal from a final Order of the United States District Court for the Southern District of California, Northern Division, by Judicial Code Sections 1291 & 1294(2), 28 U.S.C. Sections 1291 & 1294(2), and Bankruptcy Act Sections 24a & 25a, 11 U.S.C. Sections 47a & 48a.

No written notice of entry of judgment was served upon Appellant. The Order appealed from involves a sum in excess of \$40,000.00 (R. 35).

* Citations to the Record on Appeal throughout Appellant's briefs are in the above form, which indicates the page in the (Clerk's) Transcript of Record. There is no reporter's transcript.

STATEMENT OF THE CASE

This appeal involves proceedings originally commenced by a partnership named, "Park Terrace," which filed a petition for an arrangement under Chapter XI of the Bankruptcy Act on September 30, 1964. The partnership was appointed debtor-in-possession of its properties, which included an apartment building known as "Park Terrace Apartments" (R. 20).

On October 2, 1964, the partnership, debtor-in-possession, filed a petition for an order to show cause re nature and validity of the lien claimed by Appellee to the rents of the Park Terrace Apartments (R. 2-4; R. 19). On March 16, 1965, the Referee in Bankruptcy filed his Findings of Fact, Conclusions of Law, and Judgment, which determined the issues raised by the Petition filed on October 2, 1964 (R. 19-25, Findings, etc.).

Previous to the entry of the Referee's Judgment on January 26, 1965, the partnership was adjudicated a bankrupt and Appellant was appointed trustee of the bankrupt's estate (R. 22; R. 18).

Appellant, being aggrieved by the Referee's Judgment petitioned the District Court for review (R. 27-8, Petition for Review), on March 26, 1965. The review proceeding was determined adversely to Appellant by an Order of the Honorable M. D. Crocker, District Judge, entered on November 5, 1965, (R. 36-8, Order Affirming Referee's Order).

The issue before the referee, on review, and on this appeal is whether Appellee had taken, before bankruptcy proceedings began, the steps required to perfect a pledge of rentals made in a deed of trust



held by Appellee ("Respondent's Exhibit 'E' "). This issue was tried to the Referee in. Bankruptcy on October 16, 1964 (R. 19).

Parenthetically, it must be noted that Appellee has collected all of the rentals falling due after the bankruptcy (Chapter XI) proceedings were commenced on September 30, 1964. The Referee's Order to Show Cause (R. 6-8) restrained Appellee from "any act or proceeding in the enforcement of its lien or liens on the property" (R. 7). This portion of the Referee's Order was modified on ex-parte application by the Honorable M. D. Crocker, District Judge, sitting as a Judge of the Bankruptcy Court, on October 5, 1964 (R. 16-17). Pursuant to Judge Crocker's modification, Appellee has collected all rental income from the apartment building during the course of the proceedings.

The fair market value of the apartment building was \$760,000.00 (R. 21). Appellee's deed of trust secured a principal balance of \$592,326.53. The total liens upon the apartment building were in the sum of \$651,000.00 (R. 21). Appellant, therefore, had an equity in the real property of \$109,000.00.

The only facts to support the rulings of the Referee and the District Court, i. e., that the assignment of rents was perfected before the Bankruptcy Court obtained jurisdiction over the apartment building, are contained in Finding VIII of the Referee. This finding, in its entirety, is as follows:

"That Petitioner (Appellant) is in default in payments of principal and interest due under the first deed of trust note in favor of Respondent (Appellee). That Respondent (Appellee) did on September 25, 1964, cause notice of the default to be recorded in the Official Records of Fresno, County, California, and did, prior to the filing of debtor's Petition herein, serve on tenants of the Park Terrace Apartments a notice to the effect that Respondent (Appellee) was exercising its right under said deed of trust to collect the rents falling due from the tenants thereafter and that said tenants should pay all such rents to Respondent (Appellee) accordingly." (R. 22).

The Referee's First Conclusion of Law was "That debtor herein (the partnership) was on September 30, 1964, at the time of the filing of the Petition herein, in possession of the premises" (R. 23). The supporting finding is finding VI, that the partnership had a managing agent residing at the apartment building on September 30, 1965, and thereafter (R. 21-22).

The Referee's Second Conclusion of Law is the one challenged by Appellant. It reads as follows:

"That Respondent, Fresno Guarantee Savings & Loan Association, did take action prior to September 30, 1964, to commence enforcement of the assignment of rents clause contained in the deed of trust described hereinabove. That by virtue thereof, said Respondent (Appellee) is entitled to the rents from said premises." (R. 23).

SPECIFICATIONS OF ERROR

(1) The Findings of Fact of the Referee in Bankruptcy, which were adopted by the District Court, do not support the Judgment and Conclusions of the Referee, which were adopted by the District Court.

(2) The District Court, in approving the decision of the Referee, erred in concluding that the assignment of rents was valid and enforceable as against the representative of the bankruptcy estate.

(3) The District Court erred in failing to sustain Appellant's objections set forth in the Petition for Review, filed on March 26, 1965.

INTRODUCTION AND SUMMARY OF ARGUMENT

Appellee failed to move for sequestration of rents of the Park Terrace Apartments. Appellee never obtained possession in accord with its deed of trust. Appellee never sought a receiver in the California Courts. Appellee never demanded possession of the Park Terrace Apartments. Appellee did not prove a deficiency or that its security was inadequate. In sum, Appellee never perfected a right to rentals of the apartment house.

The Park Terrace partnership exercised a lawful right when it petitioned the District Court for relief under Chapter XI of the Bankruptcy Act on September 30, 1964. Appellee had commenced non-judicial foreclosure and had served notice on tenants (but not the owners) that they should make payments to Appellee (R. 22). The partnership owned an interest worth \$109,000.00 more than all liens on the apartment house, including the debt secured by Appellee's trust deed. Admitedly, the partnership was in default on its obligation. Appellee's security, however, was worth more than \$167,000.00 in excess of the debt owed it (R. 21).

The question presented to this court is, simply, whether Appellee obtained a valid lien in the rentals before the Bankruptcy Court acquired exclusive jurisdiction over the property on September 30, 1964. Before the District Court, Appellee argued that equitable considerations supported the ruling of the Referee. Those arguments are far wide of the issue for two main reasons: (1) the issue is one of California real property security law only, and (2) sequestration of the rents would have been denied on the equitable ground that Appellee's security was of far greater value than the amount of indebtedness.

ARGUMENT

I. THE RULINGS OF THE DISTRICT JUDGE AND THE REFEREE IN BANKRUPTCY ARE INCONSISTENT WITH CALIFORNIA LAW.

Federal courts, exercising their bankruptcy jurisdiction, are required to apply local, State law on questions of title to and security in real property. E.g., Victor Gruen Associates, Inc. v. Glass, 338 F.2d 826, 829 (9th Cir. 1964); Judicial Code Section 1652, 28 U.S.C. Section 1652. Whether federal equity rules are additionally applicable is treated later in this brief, Section II, B. Since the federal court and the subject real property were situate in California, its law governs. The controlling decision is Malsman v. Brandler, 230 Cal. App. 2d 922, 41 Cal. Rptr. 438 (1964). This decision is not novel, it simply is an application of the law announced by the California Supreme Court in Childs Real Estate Co. v. Shelbourne Realty Co., 23 Cal. 2d 263, 143 P.2d 697 (1943), and Kinnison v. Guaranty Liquidating Corp., 18 Cal. 2d 256, 115 P.2d 540 (1941).

There can be no serious doubt that the case at bench falls squarely within the holding of Malsman v. Brandler, 230 Cal. App. 2d 922, 41 Cal. Rptr. 438 (1964), supra. The facts and the security instrument in the Malsman case and those in the instant case are compared in the two following pages.

STATE LAW

Malsman vs. Brandler
230 Cal. App. 2d 922, 41 Cal. Rptr. 438 (1964)

December 1, 1961: Trustors defaulted.
January 1, 1962: Demand made for rents.
March 27, 1962: Suit filed; receiver appointed.

Possession: Beneficiary under trust deed did not have possession until March 27, 1962.

RENTS CLAUSE

"That as additional security, Trustor hereby gives to and confers upon Beneficiary the right, power and authority, ... to collect the rents, issues and profits of said property, reserving unto Trustor the right, prior to any default by Trustor in payment of any indebtedness secured hereby ... to collect and retain such rents, issues and profits as they become due and payable. Upon any such default, Beneficiary may at any time without notice, either in person, by agent, or by a receiver to be appointed by a court, ... enter upon and take possession of said property ... in his own name sue for or otherwise collect such rents, issues and profits ... and apply the same, ... upon any indebtedness secured hereby ... The entering upon and taking possession of said property, the collection of such rents, issues and profits ... shall not cure or waive any default hereunder"

Held on appeal: The trustors "were entitled to retain the rents collected before the beneficiary took possession by the appointment of a receiver." 230 Cal. App. 2d at 924, 41 Cal. Rptr. at 441.

THIS APPEAL

Groves vs. Fresno Guarantee Svgs. & Loan Assn.

September 25, 1964: Notice of Default recorded.
September 30, 1964: Notice served on tenants.
September 30, 1964: Bankruptcy Court obtained exclusive jurisdiction.

Possession: Beneficiary under trust deed did not have possession on September 30, 1964.

RENTS CLAUSE

"As additional security, Trustor hereby gives to and confers upon Beneficiary the right, power, and authority, ... to collect the rents, issues, and profits of said property, reserving unto Trustor the right prior to any default in payment of any indebtedness secured hereby ... to collect and retain such rents, issues, and profits as they become due and payable. Upon any such default, Beneficiary may at any time without notice, either in person, by agent, or by a receiver to be appointed by a court, ... enter upon and take possession of said property ..., in its own name sue for or otherwise collect such rents, issues, and profits, ... and apply the same ... upon any indebtedness secured hereby The entering upon and taking possession of said property, the collection of such rents, issues, and profits, and the application thereof as aforesaid, shall not cure or waive any default hereunder....."

Held below: That prior to September 30, 1964, beneficiary took actions "to commence enforcement of the assignment of rents clause that by virtue thereof (beneficiary) is entitled to the rents from said premises." Conclusion II (R. 23).

In the Order appealed from, the District Judge ruled that Appellee "had taken all possible affirmative steps to perfect its right to the rents" (R. 38). This statement is badly inaccurate. California lawyers are well aware that an assignee of rents must either obtain possession or appointment of a receiver to secure a right to rents and issues of mortgaged real property, when the assignment of rents clause is written as was the one under review. The best teachers of this requirement are the Malsman case and the two California Supreme Court decisions upon which it is based.

Notice to tenants that they should pay rent to Appellee (R. 22, Finding VII), was without consequence. The assignment of rents clause in Appellee's trust deed does not require, support, or prescribe any notice to tenants. The California cases on the issue do not place any legal effect on such notices. Certainly notice to tenants must not be given any greater legal consequence than the court gave the demand for rents on January 1, 1962, in Malsman v. Brandler, supra. For a decision that notice to tenants is not equivalent to possession, see In re Sweeney, 212 Fed. 1 (3rd Cir. 1914). *

* "(W)e are advised of no statute or decision supporting the proposition that the mere notice of an asserted right to collect the rents is equivalent to possession." 212 Fed. at 3.

II. APPELLEE IS NOT ENTITLED TO THE RENTS
AS A MATTER OF EQUITY.

A. The Order Below was Inequitable and Unjust.

In its brief to the District Court, on review of the referee's judgment, Appellee argued that equity supported its claim to the rents. This contention distorts the reality and record in the present case. The apartment house was worth more than \$167,000.00 in excess of Appellee's secured debt (R. 21). Enforcement of the assignment of rents clause in Appellee's trust deed simply and effectively choked the last breath from the debtor in the Chapter XI proceedings.

Because Judge Crocker, by the modification of October 5, 1964 (R. 16-17), allowed Appellee all of the rents, the partnership was eventually adjudicated a bankrupt before the validity of Appellee's lien in the rents could be litigated (R. 22). This was manifestly inequitable and unnecessary in light of the excess value to Appellee's security. The general creditors (whose claims are reflected in the Claims Register which was brought up with the Record on Appeal) could never be induced to consent to any proposal of a debtor with no income, and a plan of arrangement became inconceivable.

To prove an equitable claim to rents, a mortgagee must show "that the mortgaged property was worth less than the mortgage indebtedness." In re Cigar Stores Realty Holdings, Inc., 69 F. 2d 823 (2nd Cir. 1934).

One of the significant equitable considerations in this matter is the brute fact that Appellee never moved to sequester the rents. In a similar case, where the mortgagee failed to seek



sequestration, Judge Learned Hand held "the mortgagee must apply to have the rents sequestered in his favor . . . they are general assets (of the bankruptcy estate) as long as he does nothing." In re Humeston, 83 F. 2d 187, 188 (2nd Cir. 1936); see also Nash v. Onondaga Hotel Corporation, 140 F. 2d 209, 211 (2nd Cir. 1944).

Appellant readily admits that the statutes and decisions governing perfection of liens by secured creditors are sometimes technical and demanding. These laws, however, embody the underlying philosophy of creditor's rights and insolvency proceedings. The writer knows of no case where a lien void against a creditor of the debtor-bankrupt has been upheld as against a trustee in bankruptcy because of an equitable recognition that the secured creditor could have perfected his lien by some course of action he failed to take. In this case the Appellee could have perfected its lien by appointment of a receiver or by taking possession. It did neither.

On the present facts, the cardinal equity is the interest of the unsecured creditors for whom Appellant is trustee. The referee destroyed the unsecured creditors' opportunity for pecuniary return by the order granting Appellant all rents. Judge Crocker's modification of the temporary order destroyed the hope for an arrangement by denying the debtor any income. The consequence of these orders was that the unsecured creditors lost the income from rents, which went to the Appellant, who already had security of a value \$167,000.00 in excess of its claim.

B. Equity Doctrines Must not be Applied to Enlarge or Restrict State-created Rights In Real Property.

A question separate and distinct from the particular equities in this case, is whether any equitable principles apply to

Appellee's rents clause, other than equitable doctrines that might apply as a matter of California real property law. The authors of IV Collier on Bankruptcy 1054-1056, IP 70.16 (14th ed. 1964), raise this separate issue by their observation that the results in some lower federal courts have been,

"that federal equitable principles have been allowed to alter the dictates of state law as to the effect of the mortgage transaction. Whether this is now permissible in light of Erie Railroad Company v. Tompkins (304 U.S. 64 (1938)) is a debatable issue." Ibid., at 1055-6.

The Supreme Court of the United States has not resolved this debate. For a general discussion of the Erie issue in a wide variety of bankruptcy contexts, see Hill, "The Erie Doctrine in Bankruptcy," 66 Harv. L. Rev. 1013 (1953), cited in Collier, supra.

Appellant submits that state law is supreme on all questions of title to and security in real property. E. g., Victor Gruen Associates, Inc. v. Glass, 338 F.2d 826, 829 (9th Cir. 1964). The substantive law, as distinguished from that which governs administration of a bankruptcy estate, is State law. Rules of Decision Act, as amended, 28 U.S.C. Section 1652, as construed in Erie R. Co. v. Tompkins, 304 U.S. 64 (1938).

Appellant does not suggest or contend that the Erie case stripped from bankruptcy courts their equity powers. In a number of post-Erie decisions the Supreme Court has approved or required use of equity powers by bankruptcy courts. Some examples are: (1) where a fiduciary has sought personal advantage, Pepper v. Litton, 308 U.S. 307 (1939), (2) where a parent organization or person is denied equal distribution with other claimants, Consolidated Rock Products Co. v.

participate with persons in the class to which his guaranty extended, American Surety Co. v. Sampsell, 327 U.S. 269 (1946), and (4) where a controlling person has mismanaged the bankrupt's estate, Taylor v. Standard Gas & Electric Co., 306 U.S. 307 (1939).

But these decisions were instances of use of equity power to prevent inequitable distributions from bankruptcy estates. See Hill, supra, 66 Harv. L. Rev., at 1020-1024. In the present case, Appellee would have this court wield equity power, in conflict with controlling State law, to achieve a patently unjust distribution of the bankrupt's assets.

The Supreme Court has spoken directly, in a post-Erie case, to the present issue. The Court held that real property rights are determined under State law. Thompson v. Magnolia Petroleum Co., 309 U.S. 478, 483-484 (1940), which held that Illinois courts should decide a question of fee simple ownership of a right of way. The Court said,

"Unless the matter is referred to the State courts, upon subsequent decision by the Supreme Court of Illinois it may appear that rights in local property of parties to this proceeding have - by the accident of federal jurisdiction - been determined contrary to the law of the state which in such matters is supreme." 309 U.S. at 484.

C. The Decision of the Ninth Circuit in Pollack v. Sampsell does Not Require that Appellee's Trust Deed be Given Effect Different from the Effect it is Accorded by California Law.

Before the District Court, in the review proceedings, Appellee strenuously urged application of the equitable principles

discussed at length in Pollack v. Sampsell, 174 F.2d 415 (9th Cir. 1949). That case upheld the claim of a real property mortgagee to the proceeds of a crop harvested after bankruptcy was commenced by the mortgagor. In a scholarly treatment of the equities between the contesting parties in that matter, the court examined many of the bankruptcy precedents in the Ninth and other Circuits.

The court in Pollack v. Sampsell did not deal with the Erie doctrine because the court reached a conclusion fully consistent with State law. The court did observe, however, that the Ninth Circuit had declined to go so far as had the Seventh and Third Circuits in providing greater rights for the mortgagee "notwithstanding the contingent character of his lien" under State law. 174 F.2d at 418, 2nd col.

The determinative feature and basis of Pollack v. Sampsell, and the reason that decision does not control the instant appeal is that the result reached in Pollack v. Sampsell was also the result required by State law. See 174 F.2d at 421, n. 4, where the court held:

"Under the California decisions to the effect that unharvested crops are a part of the realty, Wilson v. White, 161 Cal. 453, 460, 119 P. 895, the same result would have followed in this case even if the trust deeds had made no mention of the rents, issues or profits."

The equities of the instant case and Pollack v. Sampsell, are diametrically opposite in a crucial respect. In the Pollack case the bankruptcy court permitted foreclosure under state law to proceed, and a foreclosure sale resulted. On appeal, the parties conceded that the foreclosure sale by the mortgagee "resulted in a deficiency in excess of the amount for which the crop had been sold." 174 F.2d at 417, 1st col. But in the present case the security was worth \$167,000.00 more than the amount of the mortgagee's (Appellee's) secured balance.

Furthermore, in Pollack v. Sampsell, supra, the mortgagee had not failed to pursue his state law remedies. That mortgagee sought equitable relief from the bankruptcy court because his security, an orange crop, actually matured after bankruptcy proceedings had commenced. In the present case, the mortgagee could have, but failed to, perfect its security interest in the rents before the bankruptcy petition was filed. Moreover, the mortgagee in Pollack v. Sampsell, sought relief from the bankruptcy court on the ground "that the land was of insufficient value to pay the secured indebtedness," 174 F.2d at 417, which obviously was not true in the instant case.

In sum, Appellant submits that no equitable consideration in this case supports the orders of the District Court and referee in bankruptcy. Appellant also submits that the controlling rule of decision is the law of California, which requires reversal of the judgment below. Finally, Appellee cannot apply the federal equity rules to this appeal, because it never invoked the equity power of the bankruptcy court by moving to sequester. See, e.g., In re Humeston, 83 F.2d 187, 188 (2nd Cir. 1936), supra.

III. ASSUMING APPELLEE HAD MOVED TO SEQUESTER,
ITS CLAIM TO THE RENTS WOULD PROPERLY
HAVE BEEN DENIED.

Had Appellee moved for sequestration, its motion would have been denied. The federal decisions are unequivocal in requiring that the mortgage security be shown inadequate before the mortgagee will be given the rents. But, before developing this point, Appellant must observe that the sequestration precedents are the very cases that Appellee argues establish its equitable right to rents.

Assuming, arguendo, that Erie R. Co. v. Tompkins does not foreclose the equity contention, that contention falls of its own weight. The sequestration cases are those which define and delimit the equitable principles and powers of the bankruptcy court. Assuming, further, that Appellee had invoked these powers by a petition to sequester, that body of bankruptcy law would have dictated denial of the rents. Thus, Appellee's entire equity argument falls with application of the rules for sequestration of rents. No one argues that the instant case is governed by any equitable principles above or beyond those expressed in the sequestration decisions.

A decision directly in point is In re Cigar Stores Realty Holdings, Inc., 69 F.2d 823 (2nd Cir. 1934). The court denied sequestration, holding, "In any event, a condition precedent to the right of the mortgagee to rents collected is proof of a deficiency." 69 F.2d at 823. In that case, fee title to the mortgaged property had been sold by the trustee in bankruptcy for a sum of \$50.00 in excess of all liens, and the court simply denied the mortgagee's claim to rents collected by the trustee, on the ground that the mortgagee

did not show "that the mortgaged property was worth less than the mortgage indebtedness." 69 F.2d at 823. Appellee has not proven a deficiency. In the Cigar Stores case, supra, the bankrupt's interest was worth \$50.00. In the present case it was worth over \$109,000.00 (R. 21).

Appellee's failure to sequester the rents may have been motivated by its mistaken belief that it had a valid lien in the rents, or by the correct belief that sequestration would be denied because the security was more than adequate. Whatever its reason, Appellee is now barred from claiming the rents, for the universal rule is that the rents subject to sequestration are those which fall due after the mortgagee's application or petition to the bankruptcy court. See, e.g., Investors Syndicate v. Smith, 105 F.2d 611, 621-622 (9th Cir. 1939), In re Humeston, 83 F.2d 187 (2nd Cir. 1936).

Moreover, a mortgagee who is entitled to rents on his application to sequester is entitled only to the net rentals, after payment of costs of administration of the bankruptcy estate and taxes. E.g., Florida Nat. Bank of Jacksonville v. United States, 87 F.2d 896 (5th Cir. 1937). If Appellee prevailed in the present proceeding, it would receive the gross rentals before payment of administration expenses.

Finally, this court has previously held that failure to sequester is fatal, where the lien to rents and issues was not perfected prior to commencement of bankruptcy. In re Hotel St. James Co., 65 F.2d 82 (9th Cir. 1933), following In re Brose, 254 Fed. 664 (2nd Cir. 1918).

CONCLUSION

Appellee did not comply with California law. The pledge of rents was never perfected as a valid security interest. Appellant's claim to the rents is of superior equity. Sequestration of the rents would have been denied. Sequestration, which is never retrospective, was not sought by Appellee.

Appellant, therefore, respectfully submits that the judgment below should be reversed and the cause remanded to the referee in bankruptcy.

Respectfully submitted,

FULLERTON, LANG & RICHERT

William T. Richert

By _____

William T. Richert
Attorneys for Appellant,
JOHN G. GROVES, Trustee

ATTORNEY'S CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated and executed this _____ day of February, 1966.

William T. Richert

WILLIAM T. RICHERT

